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Notes & Comments

Assignment of Rents Clauses under California Law and in Bankruptcy: Strategy for the Secured Creditor

*By Randy Rogers**

Commercial mortgages and deeds of trust¹ commonly contain clauses that provide for an "assignment" of the rents and profits of the mortgaged property to the lender.² These clauses are designed to give

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1. A mortgage is a lien on property which secures performance of an act or payment of a debt. *See* CAL. CIV. CODE §§ 2920, 2924, 2948 (West 1974). *See generally* G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* (1979) [hereinafter cited as OSBORNE]. In California a mortgage does not transfer title but gives the mortgagee a security interest only. *See* CAL. CIV. CODE §§ 2888, 2926 (West 1974). California thus follows the lien theory of mortgages as opposed to the title theory. *See generally* OSBORNE, *supra*, at §§ 1.4-.5. The mortgage is generally a two-party transaction. The deed of trust, in contrast, is generally a three-party transaction in which the debtor (the trustor), to secure payment of the debt, grants legal title to a third party (the trustee) who holds that title for the benefit of the creditor (the beneficiary). The deed of trust serves the same function as a mortgage and there is little practical difference between the two. *Id.* at § 1.6; *Domarad v. Fisher & Burke, Inc.*, 270 Cal. App. 2d 543, 553, 76 Cal. Rptr. 529, 535 (1969).

The deed of trust has become California's predominant real property security device through a historical anomaly. An early case, *Koch v. Briggs*, 14 Cal. 256 (1859), held that because of certain formal differences between a mortgage and a deed of trust, the latter would not be subject to the debtor protection rules governing mortgages. Not surprisingly, this led to the ascendancy of the deed of trust and the eclipse of the mortgage. *See* R. BERNHARDT, *CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE* § 3.3 (1979) [hereinafter cited as BERNHARDT]. *Koch*, however, essentially was overturned in *Bank of Italy Nat'l Trust & Sav. Ass'n v. Bentley*, 217 Cal. 644, 20 P.2d 940, *cert. denied*, 290 U.S. 659 (1933). In that case, the supreme court held that because the economic functions of the two instruments were the same, the rights and duties of the parties should also be the same. *Id.* at 657-58, 20 P.2d at 945. The advantage of the deed of trust to the creditor thus disappeared. Nonetheless, in California the deed of trust has continued to be the favored form of security interest in real property. *See* BERNHARDT, *supra*, § 3.3.

2. Assignment of rents clauses have the same effect in mortgages and in deeds of trust. In California the possessory rights of the parties to each type of instrument are the same. *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 260, 115 P.2d 450, 452 (1941); *Snyder v. Western Loan & Bldg. Co.*, 1 Cal. 2d 697, 701, 37 P.2d 86, 88 (1934). *See Domarad v. Fisher & Burke, Inc.*, 270 Cal. App. 2d 543, 553, 76 Cal. Rptr. 529, 535 (1969). Consequently, the terms "mortgages" and "deeds of trust" are used interchangeably in this

the lender³ a lien upon the rents and profits in addition to its lien upon the underlying property. The validity and scope of these security interests may come into question in bankruptcy cases. Because substantial rents and profits can accumulate during the administration of bankruptcy cases, they may be claimed by both the secured creditor, seeking to apply them to the amount of its deficit, and the bankruptcy trustee, seeking to recover them for the benefit of unsecured creditors. The Supreme Court recently discussed assignment of rents clauses in *Butner v. United States*,⁴ declaring that state law controls the validity and scope of security interests,⁵ including assignment of rents clauses, in bankruptcy cases.⁶

In California an assignment of rents clause may be either absolute, absolute conditional upon the happening of a specified event such as default, or a pledge of the postdefault rents as further security for the obligation.⁷ An absolute assignment immediately transfers to the lender the right to receive rents from the encumbered property during the term of the mortgage or trust deed. Such an assignment, however, is rarely taken by the lender.⁸ The lender normally does not want the

Note. Similarly, while the assignments usually are labeled "assignment of rents and profits," there is no distinction between the treatment accorded "rents" and that accorded "profits." For convenience, such provisions will be referred to in this Note simply as "assignment of rents clauses." Crops, however, are subject to different rules and the principles discussed in this Note do not necessarily apply to crops. See *United States v. Giragossiantz*, 488 F.2d 358 (9th Cir. 1973); *Pollack v. Sampsel*, 174 F.2d 415 (9th Cir. 1949); Smith, *Security Interests in Crops*, 10 HASTINGS L.J. (pts. 1-2) 23, 156 (1958).

3. For convenience, the terms "lender" and "borrower" are used interchangeably in this Note with the terms "creditor" and "debtor" respectively. It should be noted, however, that a deed of trust does not always involve a loan of money. A trust deed may be given to secure performance of an obligation other than the payment of a debt. See generally note 1 *supra*. Similarly, in discussions of bankruptcy, the beneficiary of a trust deed will be referred to as the "secured creditor" to distinguish it from unsecured creditors.

4. 440 U.S. 48 (1979). *Butner* is discussed in detail at notes 23-36 & accompanying text *infra*.

5. 11 U.S.C. § 101(37) (Supp. II 1978) defines "security interest" as a "lien created by agreement." Lien is defined as a "charge against or interest in property to secure payment of a debt or performance of an obligation." *Id.* § 101(28). The statutory definitions do not distinguish between real and personal property and thus, for purposes of bankruptcy, the term "security interest" applies to both real and personal property.

6. The application of state law to determine the postpetition effect of a security agreement is circumscribed by 11 U.S.C. § 552 (Supp. II 1978). See notes 37-48 & accompanying text *infra*.

7. See notes 74-103 & accompanying text *infra*. See generally BERNHARDT, *supra* note 1, §§ 7.10-.11; J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS § 2.12 (1970); J. HETLAND, SECURED REAL ESTATE TRANSACTIONS § 5.3 (1974); J. HETLAND, SECURED REAL PROPERTY TRANSACTIONS §§ 5.3-.4 (1977); 1 H. MILLER & M. STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE §§ 3.33-.35 (1975).

8. See BERNHARDT, *supra* note 1, § 7.10; J. HETLAND, CALIFORNIA REAL ESTATE SECURED TRANSACTIONS § 2.12. (1970).

burden of collecting the rents absent a default on the obligation and the borrower usually prefers to collect the rents during the term of the loan.

The other two types of assignment clauses are used more frequently⁹ and are the subject of this Note. The absolute assignment conditional upon default, hereinafter referred to as an absolute assignment, provides that rents are assigned immediately upon execution of the mortgage or deed of trust, subject to the right of the borrower to collect the rents until an event of default occurs, at which time the lender's right to collect the rents automatically arises.¹⁰ In contrast, the pledge of postdefault rents, commonly called an assignment of rents for security purposes, does not immediately assign any interest in rents. Rather, it creates only a prospective or inchoate lien in favor of the lender which must be "perfected"¹¹ after the borrower's default before the lender is entitled to the rents.¹² The lender can perfect this lien either by taking possession of the encumbered property or by obtaining the appointment of a receiver to collect the rents for its benefit.¹³

The distinction between these two types of assignments can become critical during bankruptcy cases. Upon the filing of a petition in bankruptcy, the lender is automatically stayed from taking possession of the debtor's property or obtaining the appointment of a receiver;¹⁴

9. See BERNHARDT, *supra* note 1, § 7.10.

10. See *In re Ventura-Louise Properties*, 490 F.2d 1141 (9th Cir. 1974); *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 115 P.2d 450 (1941). See notes 74-83, 103-123 & accompanying text *infra*.

11. The term "perfection," as used by the California courts when discussing assignment of rents clauses, differs from the meaning given that term by Article 9 of the Uniform Commercial Code. The two meanings should not be confused. Under Article 9 a security agreement is enforceable between the parties without the necessity of perfection. U.C.C. § 9-201. Perfection puts third parties on notice of the encumbrance of the debtor's property and enables the creditor to gain priority over certain third parties. See U.C.C. § 9-301. As used in the context of assignment of rents clauses, however, perfection is the step necessary for the creditor to enforce the lien *against the debtor*. Until the prospective lien on rents is perfected, the debtor remains entitled to all rents that it can collect. See notes 52-64 & accompanying text *infra*. A perfected lien, although valid against the debtor, nevertheless is subject to subordination in favor of a subsequently perfected senior lien. *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943); *Carlson v. Superior Court*, 2 Cal. 2d 17, 38 P.2d 149 (1934). See generally BERNHARDT, *supra* note 1, §§ 7.19-31. Thus, perfection as used in this context describes the actions that a lienor must take to be entitled to the rents vis-à-vis the debtor. The relative priority among competing perfected lienors is determined by priority of the mortgage or trust deed. *Id.*

12. *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 268, 143 P.2d 697, 700 (1943); *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 261, 115 P.2d 450, 452-53 (1941); *Lee v. Ski Run Apts. Assocs.*, 249 Cal. App. 2d 293, 297, 57 Cal. Rptr. 496, 499 (1967). See notes 52-64 & accompanying text *infra*.

13. See notes 52-64 & accompanying text *infra*.

14. 11 U.S.C. § 362 (Supp. II 1978). See generally P. MURPHY, CREDITORS' RIGHTS IN BANKRUPTCY §§ 6-01 to 6-17 (1979); 2 COLLIER ON BANKRUPTCY ¶¶362.01-.11 (15th ed. 1979); Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 3

thus, the lender is prevented from perfecting its security interest in rents. *Butner*, however, directs that a mortgagee's rights in bankruptcy should be equivalent to the rights it would have had under state law had bankruptcy not intervened. Accordingly, the mortgagee is not entitled to postpetition rents until it has taken action in bankruptcy court that approximates the steps it must take under state law to be entitled to the rents. This bankruptcy court action often has taken the form of petitioning for a sequestration of the rents.¹⁵

California law is unclear on whether an absolute assignment of rents must be perfected for the lender to be entitled to receive the rents.¹⁶ Theoretically, it need not be because the assignment by its terms is immediate and collection rights of the lender arise automatically upon default. Yet the precise question has not been considered by the California courts. If the interest need not be perfected, the secured creditor can avoid the troublesome and occasionally unsuccessful attempt to have the rents sequestered. Additionally, the secured creditor may be entitled to all rents collected by the bankruptcy trustee from the date of the filing of bankruptcy rather than from the date the appropriate action is taken in bankruptcy court.¹⁷ An absolute assignment thus would be a significant advantage to the secured creditor if the debtor enters bankruptcy.¹⁸

This Note examines assignment of rents clauses under California law and in bankruptcy cases applying California law. It first discusses *Butner v. United States*¹⁹ and concludes that the rule in that case continues to be valid under the new Bankruptcy Code.²⁰ The Note then analyzes the treatment of assignment of rents clauses under California law and discusses the steps secured creditors having either an assign-

(1978). For a discussion of the automatic stay provisions under the old Bankruptcy Act (see note 20 *infra*), see Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REF. 177 (1978); Peitzman & Smith, *The Secured Creditor's Complaint: Relief from the Automatic Stays in Bankruptcy Proceedings*, 65 CALIF. L. REV. 1216 (1977).

15. Historically, the other options available to the secured creditor have been either obtaining the appointment of a receiver or obtaining the court's consent to foreclose. See, e.g., *Fidelity Bankers Life Ins. Co. v. Williams*, 506 F.2d 1242, 1243 (4th Cir. 1974); *Central States Life Ins. Co. v. Carlson*, 98 F.2d 102, 105 (10th Cir. 1938). Under the new Bankruptcy Code, see note 20 *infra*, however, it appears that the trustee no longer has the power to appoint a receiver.

16. See notes 68-72 & accompanying text *infra*.

17. See text accompanying notes 167-68 *infra*.

18. See text accompanying 167-68 *infra*.

19. 440 U.S. 48 (1979).

20. The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 ("Bankruptcy Code" or "Code"), which went into effect on October 1, 1979, codifies and enacts title 11 of the United States Code. The Code supersedes the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 ("Bankruptcy Act" or "Act"). All cases mentioned in this Note were decided under the Act.

ment for security purposes or an absolute assignment must take to be entitled to receive the rents. The Note then demonstrates how an absolute assignment may be distinguished from an assignment for security purposes and formulates recommendations for lenders attempting to draft an absolute assignment. Finally, the Note examines the effect of each type of assignment of rents clause in bankruptcy²¹ cases applying California law. It discusses the actions that secured creditors have taken in bankruptcy court under the Act, and suggests what action secured creditors should take under the Code, to perfect their right to rents.²²

Butner v. United States

In *Butner v. United States*²³ the Supreme Court resolved a dispute among the circuit courts of appeal over the law to be applied in determining who is entitled to rents collected on mortgaged property between the date of the mortgagor's bankruptcy petition and the foreclosure sale of the mortgaged property. Five circuits, including the Ninth, had applied state law to determine whether a security interest in property extends to rents collected during bankruptcy proceedings.²⁴ Two circuits had employed a federal rule of equity that gave a mortgagee a security interest in rents regardless of whether such a right existed under state law.²⁵ A unanimous Supreme Court agreed with the majority view and held that state law will determine the scope of security

21. The effect of assignment of rents clauses in bankruptcy has received scattered attention from legal commentators over the years. See Abelow, *An Historical Analysis of Assignments of Rent in New York*, 6 BROOKLYN L. REV. 25 (1936); Gose, *The Efficacy of an Assignment of Rents and Profits in Bankruptcy*, 12 REAL PROP., PROB. & TR. J. 507 (1977); Comment, *The Mortgagee's Right to Rents and Profits Following a Petition in Bankruptcy*, 60 IOWA L. REV. 1388 (1975); Comment, *The Mortgagee's Right to Rents After Default*, 50 YALE L.J. 1424 (1941).

22. A secured creditor with a valid, perfected assignment of rents will not necessarily receive those rents if the debtor goes into bankruptcy. Various provisions of the Code subject a creditor's interest in rents to certain powers granted to the trustee. These powers are discussed in more detail at notes 167, 172-73 *infra*.

23. 440 U.S. 48 (1979).

24. The Court in *Butner* stated that the Second, Fourth, Sixth, Eighth, and Ninth Circuits had applied state law. *Id.* at 52 n.2. The cases cited are *Fidelity Bankers Life Ins. Co. v. Williams*, 506 F.2d 1242 (4th Cir. 1974); *In re American Fuel & Power Co.*, 151 F.2d 470 (6th Cir. 1945); *Tower Grove Bank & Trust Co. v. Weinstein*, 119 F.2d 120 (8th Cir. 1941); *In re Hotel St. James Co.*, 65 F.2d 82 (9th Cir. 1933); *In re Brose*, 254 F. 664 (2d Cir. 1918). See also *Central States Life Ins. Co. v. Carlson*, 98 F.2d 102 (10th Cir. 1938); *Dallas Trust & Sav. Bank v. Ledbetter*, 36 F.2d 221 (5th Cir. 1929).

25. The Court stated that the Third and Seventh Circuits had applied a federal rule of equity. The cases cited are *In re Pittsburgh-Duquesne Dev. Co.*, 482 F.2d 243 (3d Cir. 1973); *In re Wakey*, 50 F.2d 869 (7th Cir. 1931); *Bindseil v. Liberty Trust Co.*, 248 F. 112 (3d Cir. 1917). See also *Central Hanover Bank & Trust Co. v. Philadelphia & Reading Coal & Iron Co.*, 99 F.2d 642 (3d Cir. 1938).

interests in bankruptcy proceedings.²⁶

Butner involved a dispute between a bankruptcy trustee and a second mortgagee over the right to rents collected by the trustee between adjudication and foreclosure. The debtor in *Butner* filed a petition under Chapter XI of the Bankruptcy Act. Shortly thereafter the bankruptcy judge appointed an agent to collect the rents and apply them as directed by the court. The plan of arrangement was never confirmed and the debtor was adjudicated a bankrupt. A trustee was appointed and ordered to collect the rents. The trustee made no payments on the mortgages, which were then in default.

Foreclosure of the mortgaged property did not satisfy the claim of the second mortgagee, who then claimed a security interest in the rents. This claim was denied by the bankruptcy judge but granted by the district court on appeal. The district court, while recognizing that the right to rents under North Carolina law is an incident of possession, considered the appointment of an agent to collect rents during the pendency of the Chapter XI proceeding to be equivalent to the appointment of a receiver.²⁷ It reasoned that no further action by the mortgagee was necessary after conversion of the Chapter XI proceeding into straight bankruptcy.²⁸ The Fourth Circuit reversed²⁹ and held that dismissal of the agent upon adjudication made it incumbent upon the mortgagee to take further action, by petitioning either for a sequestration of the rents or for the appointment of a receiver, to secure its rights to the rents.³⁰

The Supreme Court affirmed the decision but did not consider what a mortgagee must do to perfect an interest in rents under North Carolina law. It considered only whether the Fourth Circuit was correct in deciding to apply state law to determine the existence of a security interest in bankruptcy. In approving the application of state law, the Supreme Court disapproved the equity approach of the Third and Seventh Circuits.³¹ This federal rule of equity automatically gave the mortgagee a postpetition security interest in rents regardless of whether such an interest would be recognized under state law. This equitable lien was considered fair because the bankruptcy court had taken possession of the property upon filing of the petition and thus deprived the mortgagee of its ability to perfect the security interest in state court.

The Supreme Court rejected this approach, however, primarily because it often led to a mortgagee's obtaining greater rights in the bank-

26. 440 U.S. at 54-55.

27. *See id.* at 51.

28. *See id.*

29. *Golden Enterprises, Inc. v. United States*, 566 F.2d 1207 (4th Cir. 1977).

30. *Id.* at 1210.

31. *See note 25 supra.*

ruptcy court that it would be entitled to in a comparable state court proceeding.³² The Court did note that Congress has the power to fashion a uniform rule governing the extent of a mortgagee's interest in rents in a bankruptcy proceeding,³³ but also noted that when Congress has not exercised that power the determination of property interests in a bankruptcy proceeding must be left to state law.

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."³⁴

The Court determined that the federal equity rule did not serve any identifiable federal interest. Equity, the Court said, is best achieved by ensuring that the same results obtain in bankruptcy as would obtain in a comparable state court proceeding.³⁵ The bankruptcy judge can accomplish this by requiring the mortgagee to take steps in bankruptcy court approximating the steps which that mortgagee would have had to take in state court to be entitled to rents after default. The Court suggested that by sequestering rents or by authorizing immediate state law foreclosure, the bankruptcy judge can prevent any loss the mortgagee might otherwise suffer by being denied its right to obtain possession under state law.³⁶

Continuing Validity of *Butner*

The validity of the rule in *Butner* should remain unchanged by adoption of the Bankruptcy Code. Section 552(b) of the new Code provides that a security agreement granting an interest in rents, entered into by the debtor prior to commencement of the bankruptcy case will be valid to the extent provided by the agreement and by applicable nonbankruptcy law.³⁷ Section 552(b) also provides, however, that the

32. 440 U.S. at 56.

33. *Id.* at 54.

34. *Id.* at 55 (quoting *Lewis v. Manufacturers Nat'l Bank*, 364 U.S. 603, 609 (1961)).

35. 440 U.S. at 56.

36. *Id.* at 57.

37. 11 U.S.C. § 552(b) (Supp. II 1978). Section 552 in its entirety provides as follows:

"(a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

"(b) Except as provided in sections 363, 506(c), 544, 545, 547, and 548 of this title, if the debtor and a secured party enter into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring,

bankruptcy court may contravene the terms of a valid security interest if equity so requires.³⁸ This qualification, on its face, seems to alter the rule in *Butner* by giving bankruptcy courts the equitable discretion which the Supreme Court had taken away in that case. Despite this language, an examination of rationale underlying the *Butner* decision and the legislative history of section 552 and its equitable exception indicates that application of state law is mandated under the Bankruptcy Code.

In *Butner*, the Supreme Court recognized the power of Congress to create uniform laws determining property rights in bankruptcy,³⁹ but stressed that Congress generally has left this question to state law.⁴⁰ The reluctance of Congress to enact uniform laws determining property rights in bankruptcy reflects Congress' general view that property rights are a matter of state law and that the "mere happenstance" of bankruptcy should not alter the state law result.⁴¹ Accordingly, the Bankruptcy Act did not explicitly determine the precise postpetition effect of security interests. Consequently, the Act did not preempt state laws controlling the validity and scope of security interests.

Section 552 of the new Code essentially codifies Congress' deference to state law in this area. Section 552(a) provides that property acquired by the debtor's estate after commencement of the bankruptcy case will not be subject to any lien created by a security agreement executed prior to filing.⁴² Section 552(b), however, creates a broad exception to this rule in favor of security interests in "proceeds, product, offspring, rents, or profits" of encumbered property.⁴³ Although designed primarily to allow creditors to take security interests in proceeds pursuant to Article 9 of the Uniform Commercial Code, the section extends to security interests in real property as well.⁴⁴ Section 552

rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, *except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.*" *Id.* § 552 (emphasis added).

38. *Id.* § 552(b), quoted in note 37 *supra*.

39. 440 U.S. at 54. The Constitution provides that Congress shall have authority to establish uniform laws on the subject of bankruptcy throughout the United States. U.S. CONST. art. I, § 8, cl. 4.

40. 440 U.S. at 54.

41. *Id.* at 54-55.

42. 11 U.S.C. § 552(a) (Supp. II 1978).

43. *Id.* § 552(b).

44. "Under the Uniform Commercial Code, Article 9, creditors may take security interests in after-acquired property. This section governs the effect of such a prepetition security interest in postpetition property. It applies to all security interests as defined in section 101 of the bankruptcy code, not only to U.C.C. security interests." H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 376 (1977), reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6332

is thus consistent with the approach of the Supreme Court in *Butner*, in which the Court held that a mortgagee has a right to postpetition rents once it has taken steps to obtain the rent in bankruptcy court that approximate the steps it must have taken under state law had there been no bankruptcy.⁴⁵

As mentioned, section 552(b) also provides that the bankruptcy court, "based on the equities of the case," may deviate from the general rule requiring application of state law.⁴⁶ The legislative history of section 552, however, reveals that this equity exception was intended to encompass a situation distinctly different from an assignment of rents and was not intended to resurrect the federal equity rule applied by the Third and Seventh Circuits prior to *Butner*. The House Report states that the purpose of the exception was to cover situations in which the expenditure of the estate's funds results in an increase in value of the collateral.⁴⁷ For instance, where raw materials are turned into more valuable inventory or inventory into more valuable accounts, to the extent that funds of the estate are used the funds available for general unsecured creditors are directly depleted.⁴⁸ In such situations it would be inequitable to benefit the secured party at the expense of unsecured creditors.

Collection of rents differs in part from the above examples because it involves little expense to the estate. Any administrative expenses involved in collecting rents can be routinely charged against the value of those rents under section 506(c).⁴⁹ In addition, the collection of rents does not result in any increase in value of the collateral. Thus, the equity exception provided in section 552(b) should not be applicable to rents. The general rule of section 552(b), and of *Butner*, should deter-

[hereinafter cited as H.R. REP. NO. 95-595]. See also S. REP. NO. 95-989, 95th Cong., 2d Sess. 91 (1978), reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5877 [hereinafter cited as S. REP. NO. 95-989]. For the Bankruptcy Code definition of security interest, see note 5 *supra*.

45. 440 U.S. at 56.

46. 11 U.S.C. § 552(b) (Supp. II 1978).

47. H.R. REP. NO. 95-595, *supra* note 44, at 376-77.

48. This example is given by both the House and Senate reports. H.R. REP. NO. 95-595, *supra* note 44, at 376-77; S. REP. NO. 95-989, *supra* note 44, at 91. In explanation of the compromise bill on the House floor it was noted that the equity exception allows the bankruptcy court to "evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party." 124 CONG. REC. 11,097-98 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards); see 124 CONG. REC. 17,414 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). This passage further suggests the necessity of both expense to the estate and benefit to the creditor before the equity exception is applicable.

49. "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." 11 U.S.C. § 506(c) (Supp. II 1978).

mine rights to postpetition rents.⁵⁰

The Right to Post-Default Rents under California Law

In determining the right of a secured creditor to postpetition rents, the bankruptcy court must thus look to state law. If a secured creditor is not receiving rents prior to commencement of the debtor's bankruptcy case, it must take action in bankruptcy court that approximates the action it would have been required to take under state law to receive the rents. Consequently, assessing lenders' rights in bankruptcy to postdefault rents in California necessitates examining California law governing the perfection of security interests in rents.

The Right to Rents under an Assignment of Rents for Security Purposes

An assignment of rents for security purposes must be perfected before a lender is entitled to receive the rents.⁵¹ To perfect such an interest in California, a lender either must acquire possession of the encumbered property or must obtain the appointment of a receiver to collect the rents for its benefit.⁵² Once the interest is perfected, the lender is entitled to any rents collected by it or by the receiver⁵³ because the right to rents is an incident of possession. Once a lender or receiver is in possession, the lender becomes entitled to all unpaid rents, regardless of when the right to those rents accrued. Similarly, the trustor may retain any rents collected by it prior to the secured creditor's obtaining possession.

That possession of the property or appointment of a receiver will perfect a lien on rents is long established in California and has not been questioned.⁵⁴ California courts have held that the beneficiary may take

50. The provision in § 552(b) allowing security interests to extend to property acquired after commencement of the case is expressly made subject to the provisions of §§ 363, 506(c), 544, 545, 547, & 548 of title 11. None of these sections, however, would alter the general rule discussed in the text. Section 363 deals with use, sale, or lease of property of the estate by the trustee. 11 U.S.C. § 363 (Supp. II 1978). The effect of this section is discussed more fully at notes 170-71 *infra*. Section 506(c) merely allows the trustee to recover costs of preserving secured property from the property itself. *Id.* § 506(c). Sections 544, 545, & 547 deal respectively with the trustee's rights as a lien creditor, the trustee's right to avoid the fixing of a statutory lien, and the trustee's right to avoid a preference. *Id.* §§ 544, 545, 547. Section 548 deals with fraudulent transfers and obligations. *Id.* § 548.

51. See notes 11-13 & accompanying text *supra*.

52. *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 268, 143 P.2d 697, 700 (1943). See note 54 & accompanying text *infra*.

53. See notes 62-65 & accompanying text *infra*.

54. "It is settled that where a mortgage or deed of trust contains a clause which merely includes the rents as a portion of the property pledged to secure a debt, only a security interest passes. And until a mortgagee obtains lawful possession, the mortgagor in possession may collect the rents as they fall due. Or, to put it another way, the mortgagee must actually acquire possession of the mortgaged property by consent or lawful procedure or

possession by notifying the tenants to pay rent to it⁵⁵ or by appointing an agent to collect the rents.⁵⁶ This agent can be the trustor's property manager⁵⁷ or even the trustor.⁵⁸ The beneficiary also may perfect its lien by demanding that the trustor turn over to it all rents collected by the trustor. A demand for rents, however, is sufficient only if the trustor cooperates and actually turns over the rents.⁵⁹

Should the tenants or the trustor be uncooperative and refuse to turn over the rents or give up possession, the beneficiary must take court action to perfect its right to rents. Early cases held that if prompt legal action were taken, the date of the unsuccessful demand for possession would be considered the date the interest was perfected.⁶⁰ More recent cases, however, have declined to follow this rule though they have neither disapproved nor distinguished the earlier cases.⁶¹ The leading case in this regard is *Childs v. Shelburne Realty Co.*,⁶² in which the California Supreme Court stated the general rule that a lien on rents and profits is not perfected until possession actually is taken or a receiver appointed.⁶³ The lender in *Childs* obtained possession immediately upon demand, however, so the supreme court had no reason to apply that general rule to a situation where the lender was initially refused possession. Nonetheless, the rule stated by the court is quite

must secure the appointment of a receiver in order to perfect his claim to the rents." *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 268, 143 P.2d 697, 700 (1943) (citing *Freedman's Sav. & Trust Co. v. Shepherd*, 127 U.S. 494 (1888)); *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 115 P.2d 450 (1941); *Freeman v. Campbell*, 109 Cal. 360, 42 P. 35 (1895); *Casey v. Doherty*, 116 Cal. App. 42, 2 P.2d 495 (1931)).

55. See *Johns v. Moore*, 168 Cal. App. 2d 709, 336 P.2d 579 (1959).

56. *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943); *Snyder v. Western Loan & Bldg. Co.*, 1 Cal. 2d 697, 37 P.2d 86 (1934).

57. *Snyder v. Western Loan & Bldg. Co.*, 1 Cal. 2d 697, 37 P.2d 86 (1934).

58. *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943).

59. See BERNHARDT, *supra* note 1, § 7.12.

60. In *Title Guarantee & Trust Co. v. Monson*, 11 Cal. 2d 621, 81 P.2d 944 (1938), the beneficiary demanded that the trustor turn over possession to it pursuant to the assignment of rents clause contained in the deed of trust. The trustor refused and the beneficiary brought suit to gain possession of the property. The beneficiary never sought to have a receiver appointed. Nine months later the beneficiary obtained possession. It then sued to obtain the rents collected during the interim. The trial court awarded the beneficiary damages in the amount of all rents collected by the trustor from the time the beneficiary first demanded possession until the trustor was ousted from the property. The case was appealed on other grounds and the judgment was upheld.

Monson was followed in *Mortgage Guarantee Co. v. Sampsell*, 51 Cal. App. 2d 180, 124 P.2d 353 (1942). The trustor in *Mortgage Guarantee* refused the beneficiary's demand for possession. Six days later the beneficiary had a receiver appointed. The court of appeal, citing *Monson*, held that the beneficiary was entitled to the rents collected from the date it demanded possession. *Id.* at 190, 124 P.2d at 358.

61. See notes 62-64 & accompanying text *infra*.

62. 23 Cal. 2d 263, 143 P.2d 697 (1943).

63. *Id.* at 268, 143 P.2d at 700.

clear, and *Childs* apparently has stood for the proposition that only actual possession or appointment of a receiver will perfect a security interest in rents.⁶⁴

Thus, where a demand for possession is refused by the trustor, the beneficiary ought to seek the appointment of a receiver immediately. If this is not done, the lien on rents has not been perfected and the trustor may continue to collect the rents. Once the beneficiary takes possession, it is entitled to all rents which it thereafter collects, while the trustor may retain all rents it collected before the beneficiary acquired possession. The time at which the right to those rents accrued is immaterial; possession is the determining factor.⁶⁵

64. *Lee v. Ski Run Apts. Assocs.*, 249 Cal. App. 2d 293, 57 Cal. Rptr. 496 (1967), and *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964), both followed this rule without discussion. See generally *Regalia, Receivers in California Litigation Involving Real Property*, 15 U.C.L.A. L. REV. 896, 905-10 (1968).

65. In 1942, the court of appeal in *Mortgage Guarantee v. Sampsell*, 51 Cal. App. 2d 180, 124 P.2d 353 (1942), compelled a receiver to return to the trustor all rents collected by the receiver which accrued prior to his appointment. But the following year the supreme court in *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943), without mentioning *Mortgage Guarantee*, held exactly the opposite and allowed the secured creditor to keep rents it collected which had accrued prior to the time it took possession. The supreme court surprisingly treated the issue as one of first impression. It noted a split on the question in other jurisdictions but held that "it would be inequitable if, after [the secured creditor] had established its lien by taking possession of the property, [the debtor] were allowed to collect and use the [rents] without discharging its obligation to [the secured creditor]. Such a result would defeat the lien." *Id.* at 270, 143 P.2d at 700-01. It is surprising that *Childs*, in essentially overruling *Mortgage Guarantee*, did not mention that decision or try to distinguish it. *Childs* centered around a complex fact situation involving both a deed of trust and a lease, and the issue on appeal involved rents under the lease. There is little doubt, however, that the supreme court intended its conclusion to apply to deeds of trust as well. It used the terms lessee and mortgagee interchangeably. See *id.* at 269-70, 143 P.2d at 700. The cases it cited on this point all dealt with mortgages and deeds of trust rather than leases. Finally, the language used by the court is so broad that it squarely covers mortgages and trust deeds. See *id.* *Childs* has been cited repeatedly as applying to both. See cases cited note 64 *supra*. No subsequent case has dealt with this issue, and the rule in *Childs* appears to be followed routinely. Nonetheless, *Santacrose Bros. v. Edgewater-Santa Clara, Inc.*, 242 Cal. App. 584, 51 Cal. Rptr. 613 (1966), contains the following language: "We have no doubt as to the right of the court in the present situation to appoint a receiver to enter upon and take possession of the subject property for the purpose of *collecting the rents thereafter accruing thereon.*" *Id.* at 586, 51 Cal. Rptr. at 614 (citing *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 115 P.2d 450 (1941); *Title Guar. & Trust Co. v. Monson*, 11 Cal. 2d 621, 81 P.2d 944 (1938); *Snyder v. Western Loan & Bldg. Co.*, 1 Cal. 2d 697, 37 P.2d 86 (1934)) (emphasis added). The language emphasized seems to indicate a result contrary to that reached in *Childs*. However, the point the court is trying to make in that paragraph is that a court has the power to appoint a receiver to take possession of the property and collect the rents. The authorities it cites all state this point. None of them considered whether perfection of a security interest in rents covers rents accrued but uncollected at the time of possession. Indeed, all three were decided prior to *Mortgage Guarantee* and *Childs*. The emphasized language, therefore, is most likely just a poor choice of words and was not meant to suggest that accrued but uncollected rents belong to the trustor.

The Right to Rents under an Absolute Assignment

There is little judicial guidance on the question of the right to post-default rents under an absolute assignment. The supreme court in *Kinnison v. Guaranty Liquidating Corp.*,⁶⁶ the only California case that has held an assignment of rents clause to be absolute, did not reach the question.⁶⁷ Thus, it is difficult to predict exactly what a court would require the holder of such an assignment to do to receive the rents from the encumbered property. Accordingly, the beneficiary of an absolute assignment is best advised to follow the steps required to perfect an assignment for security purposes.

The language used by the supreme court in *Kinnison* suggests that the secured creditor need take no action after default before it is entitled to the rents:

The agreement between the parties, however, either by a clause inserted in the deed of trust or mortgage or by a separate instrument, may provide that in the event of default the rents are assigned absolutely to the mortgagee. It has been held that such a provision, rather than pledging the rents as additional security, *operates to transfer to the mortgagee the mortgagor's right to the rentals upon the happening of the specified condition.*⁶⁸

If the right to rents transfers automatically "upon the happening of [a] specified condition,"⁶⁹ the lender presumably need do nothing to establish its right to the rents. The lender's right to collect rents arises automatically upon the debtor's default. Subsequent opinions citing the dicta in *Kinnison* tend to support this contention.⁷⁰ The absolute assignment at issue in *Kinnison*, however, was not contained in the deed of trust but was executed as a separate agreement after default and gave the lender immediate possession.⁷¹ Consequently, the supreme court did not determine whether the beneficiary of an absolute assignment must take any action before it is entitled to the rents.

If the right to collect rents given by an absolute assignment is held not to arise automatically upon default, the explicit language of the above cases would seem to be contradicted. Yet there is no guarantee

66. 18 Cal. 2d 256, 115 P.2d 450 (1941).

67. For further discussion of *Kinnison*, see notes 74-85 & accompanying text *infra*.

68. 18 Cal. 2d at 261, 115 P.2d at 453 (emphasis added).

69. *Id.*

70. *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943): "It is possible, by the terms of a security arrangement, or in a separate agreement, for the parties to provide that *immediately on default rents are assigned absolutely.*" *Id.* at 268, 143 P.2d at 700 (emphasis added). *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964): "It is also settled that the parties, either by a clause inserted in the deed or trust or by a separate instrument, may provide that *in the event of default the rents are assigned absolutely* to the beneficiary." *Id.* at 924, 41 Cal. Rptr. at 440 (emphasis added). See also *In re Ventura-Louise Properties*, 490 F.2d 1141, 1143, 1145 n.1 (9th Cir. 1974).

71. See text accompanying notes 74-85 *infra*.

that a California court, if confronted with the question, would hold that no action on the part of the secured creditor is necessary for it to be entitled to the rents. As mentioned earlier, the general rule regarding assignments for security purposes is that the party who collects rents is entitled to keep them regardless of who had the right to possession when the rents accrued.⁷² In the cases discussed previously, the party that had collected rents was held entitled to keep them.⁷³ In no case was a trustor forced to turn over rents that it collected prior to its ouster from the property. Thus while a California court might hold a creditor need do nothing for its right to collect rents to arise, in accord with the language in *Kinnison*, it might not hold that rents collected by the trustor after the creditor's right arose must be turned over to the creditor by the trustor. The creditor's right, therefore, would be meaningless absent some action by the creditor to acquire actual or constructive possession. Perhaps California courts will require the secured creditor to take some action less time-consuming and burdensome than obtaining possession or the appointment of a receiver. They could require a demand for possession or a demand for the rents, even though not successful, or perhaps some form of notice to the debtor that the secured creditor is seeking to exercise its right to the rents under its absolute assignment.

Because of this uncertainty the secured creditor ought not to presume it need do nothing to be entitled to the rents. To be safe it should make an immediate demand for the rents and, if this is refused, should take the steps necessary to perfect an assignment for security purposes.

Distinguishing an Absolute Assignment of Rents from an Assignment for Security Purposes under California Law

Because of the dearth of case law concerning absolute assignments, a lender cannot be certain that a particular clause will be deemed an absolute assignment by the California courts. No California case has ever held an assignment of rents clause contained in a mortgage or deed of trust to be an absolute assignment. In *Kinnison v. Guaranty Liquidating Corp.*,⁷⁴ where the existence of such a clause was first recognized, the assignment was executed after default, thus providing limited guidance on how to draft an absolute assignment in a deed of trust. Other California cases, however, have discussed the criteria

72. See notes 52-65 & accompanying text *infra*.

73. *Mortgage Guarantee Co. v. Sampsell*, 51 Cal. App. 2d 180, 124 P.2d 353 (1942), is the only exception. The result in that case, however, was overturned by *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943). See note 65 *supra*.

74. 18 Cal. 2d 256, 115 P.2d 450 (1941).

necessary for an assignment of rents clause to be considered absolute.⁷⁵ The following discussion of these opinions suggests that whether an assignment is absolute or for security purposes is controlled by the intent of the parties.⁷⁶ In determining that intent, the wording and placement of the clause within the deed of trust are the crucial factors.

The *Kinnison* case arose out of a dispute between a trust deed beneficiary and a judgment creditor over certain rents collected by a building owner. To finance a building, the debtor, Bartlett Corporation, borrowed \$835,000 from Pacific Mutual Life Insurance Company and executed a deed of trust as security. Approximately three years later, while Bartlett was in default under the first deed of trust, the parties replaced it with a second deed of trust. Both deeds of trust were accompanied by assignments of the rents from a theater in Bartlett's building as additional security for the loan. About two years after the replacement of the first deed of trust, while Bartlett was again in default, the parties entered into two agreements. The first assigned to Pacific Mutual all the rents accruing from the building, including rents from offices and stores as well as the rents from the theater that had already been assigned as additional security. This instrument provided:

Bartlett hereby (1) grants, transfers, assigns and sets over to the Pacific Mutual Life Insurance Company of California . . . "said property income, together with the right to collect and/or compromise the same in whole or in part and/or to enforce the payment of all or any part thereof . . . as the insurance company may deem proper"⁷⁷

The second agreement provided that Bartlett would collect all rents for the account and benefit of Pacific Mutual. Bartlett thereafter collected the rents and deposited them in its own general account. Monthly payments were made to Pacific Mutual in accordance with the agreements, but the bank account was kept in Bartlett's name. Guaranty Liquidating Corporation, a judgment creditor of Bartlett, levied a writ of execution on Bartlett's bank accounts and claimed the rents held

75. See notes 85-102 & accompanying text *infra*. Several pre-*Kinnison* cases considered the effect of assignment of rents clauses in mortgages and deeds of trust. Title Guar. & Trust Co. v. Monson, 11 Cal. 2d 621, 81 P.2d 944 (1938); Carlon v. Superior Court, 2 Cal. 2d 17, 38 P.2d 149 (1934); Snyder v. Western Loan & Bldg. Co., 1 Cal. 2d 697, 37 P.2d 86 (1934); Bank of America Nat'l Trust & Sav. Ass'n v. Bank of Amador County, 135 Cal. App. 714, 28 P.2d 86 (1933). Some of these cases occasionally are cited as examples of absolute assignments. See, e.g., 1 MILLER & STARR, *supra* note 7, at 377 n.161. None of the pre-*Kinnison* cases, however, used the term absolute assignment. Indeed, prior to *Kinnison* the concept of an absolute assignment had not been recognized in California. All of the above cases treated assignment of rents clauses in the only way conceivable at the time—as provisions for additional security. To characterize a pre-*Kinnison* case as an absolute assignment of rents would be to attribute to it by hindsight a meaning it could not have had at the time.

76. See text accompanying notes 74-85 *infra*.

77. 18 Cal. 2d at 262-63, 115 P.2d at 453-54 (omissions by the court).

in that account. The trial court found that the assignment clause was valid and that the rents were held for the benefit of Pacific Mutual.⁷⁸

On appeal, the California Supreme Court considered the validity of this assignment clause. The court first noted that clauses in mortgages that assign rents normally transfer only a security interest.⁷⁹ Under such circumstances, the mortgagee must first perfect its interest in the rents, either by taking possession of the property or by securing the appointment of a receiver, before it is entitled to receive the rents.⁸⁰ However, the court stated:

the parties . . . may provide [instead] that in the event of default the rents are assigned absolutely to the mortgagee. It has been held that such a provision, rather than pledging the rents as additional security, operates to transfer to the mortgagee the mortgagor's right to the rentals upon the happening of the specified condition.⁸¹

Some jurisdictions, the court pointed out, refuse to enforce such clauses either on the ground that the mortgagee's rights are governed exclusively by state statutes or because the courts simply "are reluctant to find that a complete transfer of the mortgagor's possessory rights was intended despite the use of language of assignment rather than hypothecation."⁸² The better view, according to the court, is that such agreements be enforced in accord with the intent of the parties: "The decisive question is whether the parties contemplated an assignment of the rentals or merely a pledge of the rentals for security purposes."⁸³

The court held the assignment in *Kinnison* to be an absolute assignment of the rents. The court emphasized several factors in making this determination. Pacific Mutual had notified the tenants that their rents had been assigned to it by Bartlett; Bartlett had collected those rents for the benefit of Pacific Mutual and had paid them out to Pacific Mutual; the instrument itself was phrased as a complete transfer of all Bartlett's right to the rents; and, unlike the assignments executed along with the trust deeds, there was no provision allowing the debtor to continue collecting rents until the happening of a specified condition.⁸⁴ In addition, the court noted that Bartlett could not regain its right to receive rents. Instead, the right to rents was given up completely, in partial satisfaction of the outstanding indebtedness to Pacific Mutual.⁸⁵

78. See *id.* at 259, 115 P.2d at 452.

79. *Id.* at 261, 115 P.2d at 452-53.

80. *Id.*

81. *Id.* at 261, 115 P.2d at 453. *Kinnison* cites *Paramount Bldg. & Loan Ass'n v. Sacks*, 107 N.J. Eq. 328, 152 A. 457 (1930), and *Grannis-Blair Audit Co. v. Maddux*, 167 Tenn. 297, 69 S.W.2d 238 (1938), in support of this point.

82. 18 Cal. 2d at 261-62, 115 P.2d at 453 (citations omitted).

83. *Id.* at 262, 115 P.2d at 453.

84. *Id.* at 263, 115 P.2d at 454.

85. *Id.*

Thus, the court concluded the parties hardly could have intended the assignment to be merely the transfer of a security interest.

Kinnison establishes that the characterization of an assignment as absolute or for security purposes will depend upon the intent of the parties. The actual language used in the instrument in that case, however, provides little guidance because of the unique fact situation involved. The assignment was made, not contemporaneously with the deed of trust, but only after default under that deed of trust and as partial satisfaction of the existing debt. It was primarily from these facts, and not from the language of the instrument, that the court inferred that the parties intended an absolute assignment.⁸⁶

Whether a particular clause constitutes an absolute assignment was next considered in *Childs v. Shelburne Realty Co.*,⁸⁷ in which the supreme court found the following language to create an assignment for security purposes: "[I]n case default is made by lessee . . . the lessor at its option may at any time . . . declare this lease terminated . . . and may thereupon or at any time thereafter enter into and upon said demised premises . . . and the lessee hereby waives in such event any demand for the possession of said demised premises."⁸⁸ In deciding that the clause did not constitute an absolute assignment, the court failed to offer an explanation as to the elements of an absolute assignment. Rather, the court said only that to be an absolute assignment

86. *Id.* Just one year after *Kinnison*, the court of appeal in *Mortgage Guaranty Co. v. Sampsell*, 51 Cal. App. 2d 180, 124 P.2d 353 (1942), without discussion treated the following assignment as one for security purposes: "[I]n the event of any breach or default by TRUSTOR in the payment of any indebtedness secured hereby, or in the performance of any obligation, covenant, promise or agreement in this Deed of Trust or in any note secured thereby, or in the event of waste as defined herein, the BENEFICIARY shall be entitled, at its option, without notice, either by itself or by a receiver to be appointed by a Court therefor, and without regard to the adequacy of any security for the indebtedness secured hereby, to enter upon and take possession of the property conveyed hereby, or any part thereof, exclude TRUSTOR and all persons claiming under him, and do and perform any acts which the TRUSTOR is obligated hereunder to do or perform, in such manner and to such extent as may be necessary or proper to conserve the value of said property and protect the security of this Deed of Trust, and collect and receive the rents, issues and profits thereof and apply the same, less costs of operation and collection, including reasonable attorney's fees, upon the indebtedness secured by this Deed of Trust, said rents, issues and profits being hereby assigned to the BENEFICIARY as further security for the payment of all indebtedness secured hereby." *Id.* at 181-82, 124 P.2d at 353-54 (emphasis by the court). *Mortgage Guaranty* considered what a secured creditor must do to receive postdefault rents under an assignment of rents for security purposes. See note 60 *supra*. Presumably because of the explicit language ("hereby assigned . . . as further security"), neither party disputed the court's characterization of the assignment clause as one for security purposes. Indeed, the case never mentions *Kinnison* at all.

87. 23 Cal. 2d 263, 143 P.2d 697 (1943).

88. *Id.* at 266, 143 P.2d at 698 (emphasis added). *Childs* involved a lease rather than a deed of trust, but the language of the supreme court indicated that it treated the lease as it would treat a deed of trust. See note 65 *supra*.

there must be an "immediate transfer [as] distinguished from an ordinary pledge of additional security"⁸⁹ and that such must be the "clearly expressed intention"⁹⁰ of the parties.

The only in depth discussion by a California court of the requirements of an absolute assignment is contained in a 1964 appellate court decision, *Malsman v. Brandler*.⁹¹ At issue was the effect of an assignment of rents contained in a second deed of trust. The assignment included the following language:

[Trustor] "grants, transfers and assigns" to the trustee, in trust, the real property described. "Together with the rents, issues and profits thereof, subject, however, to the right, power and authority given to and conferred upon Beneficiary by paragraph 10 . . . to collect and apply such rents, issues and profits. . . .

"(10) That as additional security, Trustor hereby gives to and confers upon Beneficiary the right, power and authority . . . to collect the rents, issues and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby . . . to collect and retain such rents, issues and profits as they become due and payable. *Upon any such default, Beneficiary may at any time without notice . . . enter upon and take possession of said property . . . in his own name sue for or otherwise collect such rents, issues and profits . . . and apply the same . . . upon any indebtedness secured hereby . . .*"⁹²

On December 1, 1961, the trustor defaulted on a payment under the deed of trust. On January 1, 1962, the trust deed beneficiary notified the trustor of its default and demanded that the trustor pay to it any rents collected from the encumbered property. The trustor nonetheless continued to collect the rents for its own benefit until suit was filed and a receiver appointed on March 27, 1962. The trial court held that the assignment was for security purposes and that the beneficiary did not elect to demand possession until it filed a complaint on March 27, 1962.⁹³ Until this demand was made, the beneficiary's lien remained unperfected.⁹⁴ The trustor therefore was allowed to retain all rents collected prior to March 27, 1962. On appeal, the beneficiary contended that under the terms of the second deed of trust it was entitled to the rents as soon as the trustor defaulted, without having to take or demand possession.

The court of appeal, citing *Kinnison* and *Childs*, recognized that the parties to a trust deed may provide that rents are assigned abso-

89. 23 Cal. 2d at 268, 143 P.2d at 700.

90. *Id.*

91. 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964). See generally Johnson, *Assignment of Rents: Malsman v. Brandler Makes Old Law*, 40 L.A.B. BULL. 538 (1965).

92. 230 Cal. App. 2d at 924, 41 Cal. Rptr. at 440 (emphasis added).

93. *Id.* at 923, 41 Cal. Rptr. at 439.

94. See notes 52-65 & accompanying text *supra*.

lutely to the beneficiary in the event of default and that such an assignment, instead of pledging those rents as additional security, automatically transfers the right to collect those rents upon default.⁹⁵ The court held for several reasons, however, that paragraph (10) of the trust deed was not a "clearly expressed intention"⁹⁶ of the parties that the assignment be absolute. First, paragraph (10) contained no language that specifically assigned the rents to the beneficiary, those rents having previously been assigned to the trustee as security. Second, the opening phrase of paragraph (10)—"[t]hat as additional security"—suggested an intent that the assignment be solely for security. Third, the agreement stated that the trustor conferred the power to collect rents upon the beneficiary subject to the trustor's right to collect those rents prior to any default. This, the court said, does not indicate an intent that the rents be assigned absolutely upon default, but merely that upon a default the beneficiary *may* exercise the right to collection. Similarly, the text of the trust deed taken as a whole indicated that the beneficiary's power to collect rents could only be exercised after the beneficiary had taken possession.⁹⁷

95. 230 Cal. App. 2d at 923-24, 41 Cal. Rptr. at 439-40.

96. *Id.* at 925, 41 Cal. Rptr. at 440.

97. *Id.* at 924-25, 41 Cal. Rptr. at 440-41. Two years after *Malsman*, the court of appeal in *Santacroce Bros. v. Edgewater-Santa Clara, Inc.*, 242 Cal. App. 2d 584, 51 Cal. Rptr. 613 (1966), encountered an assignment of rents clause which was almost identical to the one in *Malsman*. *Santacroce Bros.* arose out of a trustor's appeal from an order appointing a receiver. Since the beneficiary had perfected its security interest in the rents by securing the appointment of a receiver, see notes 52-65 & accompanying text *supra*, the court did not have to face directly the question whether the assignment was absolute or for security. Accordingly, the assignment was presumed, without discussion, to be for security purposes.

The next year, in *Lee v. Ski Run Apts. Assocs.*, 249 Cal. App. 2d 293, 57 Cal. Rptr. 496 (1967), the following unusual language was held to create an assignment of rents for security purposes: "[T]he trustor grants in trust to the trustee certain described land in El Dorado County 'together with all appurtenances in which Trustor has any interest, including water rights benefiting said realty whether represented by shares of a company or otherwise; and profits of said realty, reserving, however, the right to collect and use the same except during continuance of default hereunder and during continuance of such default authorizing Beneficiary to collect and enforce the same by any lawful means in the name of any party hereto. For the purpose of securing: (1) Performance of each agreement of Trustor incorporated by reference or contained herein; (2) payment of the indebtedness evidenced by one promissory note of even date herewith in the principal sum of \$65,000.00 payable to Beneficiary or order; (3) the payment of any money that may be advanced by the Beneficiary to Trustor, or his successors, with interest thereon.'" *Id.* at 296-97, 57 Cal. Rptr. at 499. At issue was the right to postdefault rents collected by the trustor while it remained in possession. The court stated that when the trust deed pledges the rents as additional security the trustor retains the right to rents so long as it remains in possession. It then noted the language of *Kinnison*, which established that an assignment of rents can be absolute upon the trustor's default, but summarily concluded that "there is no such absolute assignment in this case." *Id.* at 297, 57 Cal. Rptr. at 499. The court gave no explanation why it considered the assignment of rents clause to be for security purposes. Because of the court's failure to explain its conclusion and because of the unusual and confusing language of the part of the trust deed which is

The Elements of an Absolute Assignment

The above cases demonstrate that the California courts have not precisely indicated the distinction between an absolute assignment of rents and a pledge of rent for security purposes. Several factors nonetheless can be gleaned from the cases which help to distinguish the two.

First, there appears to be a presumption that assignment of rents clauses create a security interest. If the parties intend the assignment to be absolute, such an intent must be "clearly expressed."⁹⁸ Presumably, this can be done through the use of clear and absolute language in the assignment clause. A statement such as "trustor hereby absolutely and irrevocably assigns" should be sufficient. Second, if the term "as additional security" or its equivalent precedes the rents clause or in any way modifies it, the assignment most likely will be deemed to be for security purposes.⁹⁹ Third, if the assignment of rents clause is contained in the portion of the deed detailing the security agreement, it may be construed as creating only a security interest.¹⁰⁰ Therefore, the assignment must be given a distinct heading and should be completely separate from the listing of obligations secured by the deed of trust. Fourth, if a portion of the deed first assigns the rents to the trustee as security, later language conferring collection rights upon the beneficiary will be subordinated.¹⁰¹ Thus, probably no mention of rents whatsoever should be made in the granting portion of the deed of trust.

The crucial factor, however, appears to be the requirement of taking possession. If the deed requires the beneficiary to take possession or its equivalent before it becomes entitled to rents, the assignment clause likely will be held to be for security purposes.¹⁰² This is not surprising because if the deed requires possession, distinguishing between the two types of assignment becomes moot.¹⁰³ The action that a

quoted by the court, *Lee* is not very instructive as to what distinguishes an absolute assignment of rents from a pledge of those rents as security. The trust deed used the words "for the purpose of securing" immediately following the clause discussing rents. This could indicate that the rents were to be pledged as additional security. From the language quoted in the opinion, however, it cannot be determined whether that phrase modifies the clause discussing rents or the entire agreement.

98. *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 268, 143 P.2d 697, 700 (1943). See *Kinnison v. Guaranty Liquidating Corp.*, 18 Cal. 2d 256, 115 P.2d 450 (1941); *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964).

99. See *Lee v. Ski Run Apts. Assocs.*, 249 Cal. App. 2d 293, 57 Cal. Rptr. 496 (1967); *Santacrose Bros. v. Edgewater-Santa Clara, Inc.*, 242 Cal. App. 2d 584, 51 Cal. Rptr. 613 (1966); *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964).

100. See *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964).

101. *Id.*

102. See *Childs v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943); *Lee v. Ski Run Apts. Assocs.*, 249 Cal. App. 2d 293, 57 Cal. Rptr. 496 (1967); *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964).

103. See notes 52-72 & accompanying text *supra*.

creditor must take to receive rents under the instrument is the same action required to perfect a security interest in rents. Thus, to be an absolute assignment, an assignment of rents clause should indicate that the creditor is entitled to the rents without first having to take possession.

The trust deed in *Malsman* read: "Upon . . . default, Beneficiary may . . . enter upon and take possession of said property . . . sue for or otherwise collect such rents" ¹⁰⁴ The court in *Malsman* interpreted this language as suggesting that the beneficiary's right to collect rents was contingent upon its first taking possession. This indicates that to be an absolute assignment, the right to rents and the right to post-default possession should be separate and should be carefully distinguished. Any juxtaposition of the two suggests that possession is a prerequisite to the right to rents.

Because of the paucity of California case law establishing the requirements for an absolute assignment of rents, a secured creditor attempting to draft such an assignment cannot be certain of the label that will be given to that clause by a court. Therefore, it is imperative that the deed of trust contain all of the above elements.

Ventura-Louise

In a 1974 bankruptcy case, *In re Ventura-Louise Properties*, ¹⁰⁵ the Ninth Circuit, applying California law, held an assignment of rents clause in a deed of trust to be an absolute assignment. Relying solely on the dictum in *Kinnison*, ¹⁰⁶ *Ventura-Louise* became the first case actually to find an absolute assignment of rents contained in a trust deed. The interpretation of California law in *Ventura-Louise* is questionable, however, because the language of the deed seemed to require that the beneficiary take possession before being entitled to rents. ¹⁰⁷ Nonetheless, *Ventura-Louise* is a significant case because it was the first decision to establish that absolute assignments would be recognized in bankruptcy proceedings.

Ventura-Louise involved a second trust deed, containing an assignment of rents clause, under which the trustor defaulted. Shortly after default, the lender notified each tenant on the encumbered property that it was exercising its right to collect the rents under the assignment of rents clause and demanded that all rents be paid to it. Six weeks later the debtor filed a Chapter XII petition in bankruptcy. A trustee was appointed who then notified all tenants that they were to pay rent

104. 230 Cal. App. 2d at 924, 41 Cal. Rptr. at 440 (emphasis added).

105. 490 F.2d 1141 (9th Cir. 1974).

106. See notes 68-69 & accompanying text *supra*.

107. See text accompanying note 109 *infra*.

to the trustee. The lender, to ensure that the tenants would not withhold rent because of conflicting demands for payment, agreed to let the trustee collect the rents. During the bankruptcy proceeding the lender took no steps to have the rents sequestered or otherwise collected for its benefit.¹⁰⁸

Almost two years after filing of the petition, the property was sold at a foreclosure sale, but the proceeds of the sale did not cover the indebtedness. During this period the trustee collected some \$75,000 in rents. The lender claimed these rents under the assignment of rents clause in the deed of trust. The bankruptcy court denied the claim and the district court affirmed the denial.¹⁰⁹ On appeal, the Ninth Circuit characterized the case as presenting two issues: first, whether the assignment of rents clause was absolute or for security purposes only; and second, if the assignment was for security purposes, whether the lender had perfected its interest.¹¹⁰ By deciding that the assignment was absolute, the court never had to reach the second issue. The assignment of rents clause provided:

B. Should Trustor fail . . . [to] do any act which he is obligated hereunder to . . . do . . . then Trustee and/or Beneficiary each in its sole discretion, it being hereby made the sole judge of the legality thereof, may . . .

1. [perform the obligation] in such manner and to such extent as either may deem necessary to protect the security hereof, either Trustee or Beneficiary being authorized to enter upon or take possession of said property for such purpose . . .

. . . .

3. Beneficiary is authorized . . . to enter into and upon and take and hold possession of any or all property covered hereby and exclude the Trustor and all other persons therefrom; and may operate and manage the said property and rent and lease the same and collect any rents, issues, income and profits therefrom, and from any personal property located thereon, *the same being hereby assigned and transferred for the benefit and protection of the Beneficiary* . . .¹¹¹

The court first cited *Kinnison* for the proposition that an assignment of rents in California may be either absolute or for security purposes. It stressed that whether an assignment is absolute or for security purposes is to be determined by the intent of the parties.¹¹² The court expressly rejected the trustee's argument that the absolute assignment discussed in *Kinnison* applied only where there is an immediate transfer of the right to collect the rents.¹¹³ The court then distinguished *In re*

108. 490 F.2d at 1142.

109. *See id.*

110. *Id.* at 1143.

111. *Id.* (emphasis by the court).

112. *Id.* at 1144.

113. *Id.*

Hotel St. James Co.,¹¹⁴ an earlier Ninth Circuit decision adjudicating a beneficiary's right to rents in bankruptcy.

The beneficiary's claim to rents in *Hotel St. James* was denied, explained the *Ventura-Louise* court, because it had failed to perfect its security interest in the rents by taking possession. In *Ventura-Louise*, on the other hand, the assignment of rents clause was held not to require possession: "Here the terms 'authorized to enter' and 'may operate and manage' are used as distinguished from the *Hotel St. James* clause which uses the term 'shall',—connotating a condition for perfecting the security interest by entering into possession."¹¹⁵ *Hotel St. James* was further distinguished because the rents clause in that case did not use the term "assignment" which was used in *Ventura-Louise*.¹¹⁶ In addition, the assignment language in *Ventura-Louise* was not tempered by any express limitation such as the words "additional security" found in *Malsman*.¹¹⁷

The court's reasoning in holding that the assignment in *Ventura-*

114. 65 F.2d 82 (9th Cir. 1933). The clause involved in *Hotel St. James* stated:

"If one or more of the events of default shall happen, the Trustee . . . shall enter . . . and take . . . possession of the trust estate . . . and may . . . operate . . . the estate, and conduct the business thereof to the best advantage of the holders of the bonds secured hereby. . . .

"The Trustee shall be entitled to the appointment of a receiver of the trust estate and of the earnings, rents, dividends, income, interest and profits thereof. . . ." *Id.* at 84 (omissions by the court).

115. 490 F.2d at 1144. Paragraph B.3. of the agreement involved in *Ventura-Louise* authorized the beneficiary to "enter into . . . and hold possession . . . of [the] property . . . and exclude the Trustor . . . therefrom; and may operate . . . [the] property and rent . . . the same . . . [.] *the same being hereby assigned and transferred for the benefit and protection of the Beneficiary.*" 490 F.2d at 1143 (emphasis in original). The text of the clause is quoted in full at text accompanying note 111 *supra*. Paragraph B.3. contains two clauses. The first allows the beneficiary, upon any breach by the trustor, to enter the property and exclude the trustor. The second allows the beneficiary to operate and manage the property, rent and lease the same, and collect any rents and profits therefrom. The language seems to indicate that possession is required before the beneficiary is entitled to collect any rents. The second clause is dependent on the first. The beneficiary must first enter the property and exclude the trustor, and then may manage the property and collect the rents. If the right to operate and manage the property and to collect the rents was not contingent upon the beneficiary's first taking possession, the clauses would, presumably, not have been included in the same paragraph.

Even if the clauses are construed as independent the second clause, standing alone, requires possession as a prerequisite to obtaining rents. The right to rents is granted to the beneficiary once it has begun to "operate and manage" the property. One cannot "operate and manage" property without being in possession. Under California mortgage and deed of trust law, when a trust deed beneficiary operates and manages property it is considered to be in possession. See notes 62-72 & accompanying text *supra*. Thus, although the language of the deed states that the beneficiary "may enter and manage," the right to rents is contingent upon its first exercising the option of entering and managing by taking possession.

116. 490 F.2d at 1144.

117. See notes 89-95 & accompanying text *supra*.

Louise was absolute is not persuasive. The opinion gives only a facile explanation for its holding. Apparently, the rents clause was deemed absolute because the court interpreted it not to condition the right to rents upon taking possession and because the word "assignment" was not expressly limited to encompass only a security interest. But the court, except in one sentence distinguishing *Hotel St. James*, failed to explain why it interpreted the language of the *Ventura-Louise* deed as not first requiring possession. The two phrases from the *Ventura-Louise* clause quoted by the court in distinguishing *Hotel St. James*, "authorized to enter"¹¹⁸ and "may operate and manage,"¹¹⁹ when read in context, do not suggest that the beneficiary had the right to collect rents prior to taking possession. Rather, they suggest only that the beneficiary had the customary rights of a trust deed beneficiary to enter for the purpose of preventing waste and collecting postdefault rents.

The assignment language in *Ventura-Louise* is similar to that contained in the deeds of trust considered in previous California cases. It is almost identical to the provisions examined in *Mortgage Guarantee Co. v. Sampsell*,¹²⁰ *Santacroce Bros. v. Edgewater-Santa Clara, Inc.*,¹²¹ and *Malsman v. Brandler*,¹²² all of which were held to be assignments for security purposes only. The deeds involved in those cases also used the word "assign." The only significant difference between those deeds and the *Ventura-Louise* deed is that the latter lacked the modifying words "as additional security." This difference is not dispositive. In both *Mortgage Guaranty* and *Santacroce Bros.*, the courts summarily concluded that the rents were assigned for additional security so that one cannot determine the extent, if any, to which the court relied on this phrase in determining that the assignment was for security purposes. *Malsman*, however, discussed the significance of this phrase and, contrary to the assertion in *Ventura-Louise*,¹²³ considered it only one factor indicating an intent that the rents be pledged as security.¹²⁴

Other factors mentioned in *Malsman* were not considered in *Ventura-Louise*. The assignment clause in the *Ventura-Louise* deed was contained in a part of the deed detailing the scope of the lender's security interest. If an assignment of rents is not meant solely as a security interest and is intended as an independent agreement, it presumably should warrant a separate heading. In addition, unlike the *Malsman* court, the court in *Ventura-Louise* failed to mention whether the

118. *Id.*

119. *Id.*

120. 51 Cal. App. 2d 180, 124 P.2d 353 (1942).

121. 242 Cal. App. 584, 51 Cal. Rptr. 613 (1966).

122. 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964).

123. 490 F.2d at 1144.

124. See notes 93-100 & accompanying text *supra*.

"granting" part of the trust deed granted the rents to the trustee in trust. The court's cursory dismissal of *Malsman* and its failure to mention other California cases is curious. *Malsman* is the leading California case—indeed it is the only California case—that contains an analysis of the requirements of an absolute assignment of rents.

Likewise curious is the court's use of innaposite authority. *Hotel St. James* is an important case, but for a different point. *Hotel St. James* did not attempt to distinguish between an absolute assignment of rents, which was not recognized in California until eight years later, and an assignment for security purposes.¹²⁵ Rather, it considered only the steps that a mortgagee must take to perfect a security interest in rents.

The decision in *Ventura-Louise* is a questionable interpretation of California law. It found an absolute assignment of rents in a clause which seemed to require the beneficiary first to take possession. It ignored all but one of the criteria mentioned in *Malsman* and attributed to *Kinnison* a scope never attributed to that decision by the California courts. Bankruptcy courts in California, faced with a creditor claiming an absolute assignment of rents will be in the unfortunate position of having to choose between applying California law and applying *Ventura-Louise*. Nonetheless, *Ventura-Louise* remains the law in the Ninth Circuit. Thus, an assignment of rents clause similar to the one in *Ventura-Louise* may well constitute an absolute assignment in bankruptcy proceedings in that Circuit. A secured creditor attempting to draft an absolute assignment of rents is best advised, however, to fulfill all the requirements of *Malsman*. If those requirements are met, a secured creditor seems assured of having the assignment clause labeled absolute. The Ninth Circuit in *Ventura-Louise* expressly recognized the efficacy of such assignments in bankruptcy cases.

Perfecting an Assignment of Rents in Bankruptcy Court

The secured creditor who has not obtained possession or the appointment of a receiver prior to institution of a bankruptcy case is restrained from doing so thereafter because of the automatic stay.¹²⁶ In

125. The court also mentioned *Associated Co. v. Greenhut*, 66 F.2d 428 (3d Cir. 1933), which held a rents clause to be an absolute assignment and consequently found that possession was not a prerequisite to the mortgagee's right to rents. In that case, the Third Circuit, commenting in dictum on the law of New Jersey, said that an assignment was absolute upon default. *Id.* at 429. The court gave no reasons why it considered the assignment to be absolute, nor did it quote the language of the clause. Accordingly, it is difficult to see the relevance of the case.

126. See text accompanying note 14 *supra*.

Butner v. United States,¹²⁷ however, a secured creditor was permitted to perfect its lien on rents after the bankruptcy petition was filed by taking action in the bankruptcy court that approximated the action it would have had to take in state court to perfect that interest. Early Ninth Circuit cases held that petitioning the bankruptcy court for sequestration of the rents was equivalent to demanding possession under state law and thus, when granted, the sequestration order would perfect the lien.¹²⁸ Later cases held that certain actions less formal than the entering of a sequestration order would be sufficient for perfection.¹²⁹ There was thus some uncertainty about what actions were required under the Act to perfect a lien on rents after filing. This uncertainty may be mooted by the new Code which would seem to allow perfection by notice.¹³⁰ Nonetheless, the secured creditor is best advised to seek sequestration of the rents because it is the most certain method of perfecting the lien.

Perfecting an Assignment for Security Purposes

The Ninth Circuit first determined what actions are required to perfect a security interest in rents in *In re Hotel St. James Co.*¹³¹ *Hotel St. James* involved a secured bondholder's claim for rents and profits collected by a receiver and by a trustee in bankruptcy between the time the debtor was adjudicated a bankrupt and the foreclosure sale of the property. The Ninth Circuit upheld the referee's decision to disallow the claim. The trust indenture provided that if the debtor defaulted, the indenture trustee could take possession of the property or secure a receiver and thereafter would be entitled to the rents.¹³² The provision was similar to that presently termed an assignment of rents for security purposes.

The Ninth Circuit held that the bondholder was not entitled to the rents under the terms of the indenture because it neither took possession or sought to have a receiver appointed before bankruptcy, nor did it make any attempt after the bankruptcy petition was filed to have the rents sequestered.¹³³ No claim for the rents was made until after the foreclosure sale. The court noted the general rule that possession, appointment of a receiver, or a proper demand for possession is necessary before a mortgagee can be entitled to the rents.¹³⁴ This rule will be

127. 440 U.S. 48 (1979). See notes 23-36 & accompanying text *supra*.

128. See, e.g., *American Trust Co. v. England*, 84 F.2d 352 (9th Cir. 1936).

129. See, e.g., *Groves v. Fresno Sav. & Loan Ass'n*, 373 F.2d 440 (9th Cir. 1967).

130. See text accompanying note 155 *infra*.

131. 65 F.2d 82 (9th Cir. 1933).

132. The language is quoted in note 112 *supra*.

133. 65 F.2d at 84.

134. *Id.* See *Freedman's Sav. & Trust Co. v. Shepherd*, 127 U.S. 494 (1888).

followed by the federal courts, the court pointed out, unless the state in which the property is located would apply a different rule.¹³⁵ California, it noted, follows the general rule.¹³⁶ Thus, since no action for possession was taken by the secured creditor in *Hotel St. James*, that creditor was not entitled to the rents.

The court then distinguished *Mortgage Loan Co. v. Livingston*,¹³⁷ in which the Eighth Circuit had held that a secured creditor was entitled to post-petition rents. The secured creditor in *Livingston* commenced an action for foreclosure before bankruptcy and would have obtained possession but for the bankruptcy, two days after filing of the petition. Immediately upon appointment of a receiver in bankruptcy, the secured creditor petitioned for and obtained a sequestration of rents from the property. Even after obtaining the order of sequestration, the creditor "repeatedly thereafter asked leave to continue the enjoined foreclosure."¹³⁸

The brief opinion in *Hotel St. James* did not precisely indicate the action a creditor must take after filing to be entitled to the rents. In distinguishing *Livingston*, the Ninth Circuit only indicated that if a secured creditor attempts to obtain possession of the property before the institution of bankruptcy proceedings and obtains a sequestration of the rents afterward, it will be entitled to the rents.¹³⁹

Just three years later, in *American Trust Co. v. England*,¹⁴⁰ the Ninth Circuit held that a demand for a sequestration of the rents followed by a sequestration order is the equivalent of possession, thus entitling the secured creditor to the rents and profits. The mortgagee in *American Trust* filed a petition for sequestration of the rents and profits from a cattle ranch that was being operated by the trustee in bankruptcy. The court quoted from *Livingston* at length and then mentioned *Hotel St. James*.¹⁴¹ *Hotel St. James* was distinguished because the creditor in that case made no attempt to have the rents sequestered.¹⁴² The court held that such an attempt, if successful, is the equivalent of taking possession and thus the creditor is entitled to all rents collected from the date of its sequestration petition.¹⁴³

American Trust was relied on by the Ninth Circuit in *Groves v. Fresno Savings & Loan Association*,¹⁴⁴ in which the court held that

135. 65 F.2d at 84.

136. *Id.*

137. 45 F.2d 28 (8th Cir. 1930).

138. 65 F.2d at 85.

139. *Id.* at 84-85.

140. 84 F.2d 352 (9th Cir. 1936).

141. *Id.* at 357-58.

142. *Id.* at 358.

143. *Id.*

144. 373 F.2d 440 (9th Cir. 1967).

actions less formal than a sequestration order can be deemed the equivalent of possession under state law. The debtor in *Groves* filed a Chapter XI petition. At the time of filing, the beneficiary of the first trust deed had attempted to exercise its right to possession under the assignment of rents clause by notifying the tenants to pay rents to its agent appointed for that purpose. No rents were collected before the commencement of the Chapter XI proceedings. Shortly after filing, the beneficiary successfully petitioned the referee in bankruptcy to issue an *ex parte* order allowing the beneficiary who had remained in possession of the property to continue collecting the rents but under accountability to the court. The trustee in bankruptcy sought a review of this order. The referee found that the creditor had not taken possession before filing of the petition, but nevertheless held that the creditor was entitled to the rents.¹⁴⁵

The referee's decision was vigorously disputed before the Ninth Circuit by the bankruptcy trustee, who claimed that the creditor had not taken the action required under state law to be entitled to the rents.¹⁴⁶ The court found it unnecessary to decide the question, however, since no rents were actually collected between the time the creditor claimed to have taken possession and the time the referee issued the *ex parte* order allowing the creditor to collect the rents.¹⁴⁷ The latter event, the court said, is the equivalent of ordering a sequestration of the rents:

We think that the substantive effect of what the court did, whatever label was attached to it, was to order the sequestration of the rents, pursuant to the request for such an order contained in [the creditor's] petition In [that] document it claimed to be entitled, under the deed of trust, to collect the rents.¹⁴⁸

A sequestration of the rents, the court noted, was held to be the equivalent of possession under California law in *American Trust*.¹⁴⁹

Two months after *Groves*, in *Denco Development Co. v. Community Savings and Loan Association*,¹⁵⁰ the same court reached a similar conclusion. The secured creditor in *Denco* petitioned the referee for a sequestration of the rents. At the hearing on the petition the court-appointed receiver assured the creditor that the rents would be held for the creditor's benefit and not made part of the the bankrupt's assets available for unsecured creditors. Accordingly, a formal order of sequestration was never entered. The foreclosure sale left a deficit and the creditor sought the rents held by the receiver. The referee in bank-

145. See *id.* at 442.

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.* at 442-43.

150. 376 F.2d 548 (9th Cir. 1967).

ruptcy held that the creditor was not entitled to the rents, but the district court reversed that decision.¹⁵¹

The Ninth Circuit affirmed, relying solely on *Livingston*.¹⁵² The court stressed that the parties all understood that the receiver was collecting the rents for the benefit of the secured creditor. "As was said in [*Livingston*] 'he was their receiver.'"¹⁵³ Thus, the court held, the creditor was in "constructive possession" of the property.¹⁵⁴

The Ninth Circuit has not been explicit in detailing what a creditor must do after institution of bankruptcy proceedings to be entitled to postpetition rents. Obtaining a sequestration of the rents is certainly sufficient. Under certain circumstances receiving an equivalent assurance from the court that the rents are being held for the secured creditor's benefit also is sufficient.¹⁵⁵ To be safe a secured creditor should insist on a specific order from the court stating that the rents are being collected for the benefit of the creditor.

The Effect of the Code

The steps required to perfect an assignment of rents for security purposes under the Act should be sufficient to perfect such an interest under the new Code. Because the rule in *Butner* continues to be applicable,¹⁵⁶ those steps in bankruptcy court which in the past have approximated the necessary steps under state law will continue to do so. Perfection of a security interest in rents may be easier under the Code, however, because section 546(b)¹⁵⁷ appears to allow perfection by notice. If this is so, the actual granting of a sequestration petition, or some equivalent assurance by the court, would not be necessary to perfect the lien on rents; mere filing of the petition for sequestration would suffice.

151. See *id.* at 549.

152. *Id.* at 552.

153. *Id.* at 551.

154. *Id.*

155. The approach taken by the Ninth Circuit is quite lenient compared to that taken by other circuits. For instance, when *Butner* was decided in the Fourth Circuit, the court set a very stringent standard for what it would require a mortgagee to do to approximate the appointment of a receiver under North Carolina law. *Golden Enterprises, Inc. v. United States*, 566 F.2d 1207 (4th Cir. 1977). The Fourth Circuit required some formal action by the mortgagee after institution of bankruptcy proceedings. *Id.* at 1210-11. The Ninth Circuit's more lenient policy, however, should not be affected by *Butner*. In *Butner*, the Supreme Court considered only the propriety of applying state law. It specifically declined to consider what steps need be taken by the mortgagee after bankruptcy to approximate appointment of a receiver in state court. 440 U.S. at 58. It thought that question better left to lower court judges who are more familiar with questions of state law. *Id.* *Butner*, therefore, upholds the authority of these Ninth Circuit decisions.

156. See notes 37-50 & accompanying text *supra*.

157. 11 U.S.C. § 546(b) (Supp. II 1978). See note 161 *infra*.

The automatic stay provision of section 362¹⁵⁸ is specifically made subject to a creditor's postpetition right to perfect a lien pursuant to section 546.¹⁵⁹ Section 546 contains limitations on the trustee's avoiding powers.¹⁶⁰ The first sentence of subsection (b) of that section provides that those avoiding powers are subject to any state law that allows perfection of a security interest in property to be valid against a person who, before the time of perfection, had acquired rights in that property.¹⁶¹ The second sentence of that subsection provides that if state law requires seizure of property or commencement of an action to accomplish perfection, and the property has not been seized or the action commenced prior to the date of the filing of the petition, perfection may be obtained by notice within the time fixed by state law.¹⁶²

Section 546(b) was directed primarily toward purchase money security interests under section 9-301(2) of the Uniform Commercial Code.¹⁶³ Under section 9-301(2) a secured party has a ten day "grace period" within which to perfect a purchase money security interest.¹⁶⁴ Perfection within the ten day period enables a secured party to gain priority over an intervening lien creditor or transferee in bulk. The initial sentence of section 546(b) allows a creditor to perfect a security

158. 11 U.S.C. § 362 (Supp. II 1978).

159. 11 U.S.C. § 362(b)(3) (Supp. II 1978) provides that "[t]he filing of a petition under section 301, 302, or 303 of this title does not operate as a stay . . . under subsection (a) of this section, of any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) of this title"

160. *Id.* § 546.

161. Section 546(b) provides: "The rights and powers of the trustee under section 544, 545, or 549 of this title are subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection. If such law requires seizure of such property or commencement of an action to accomplish such perfection, and such property has not been seized or such action has not been commenced before the date of filing of the petition, such interest in such property shall be perfected by notice within the time fixed by such law for such seizure or commencement." *Id.*

162. *Id.*

163. U.C.C. § 9-301(2). Indeed, this is the only example of the intended effect of section 546(b) contained in the legislative history. See S. REP. NO. 95-989, *supra* note 44, at 86; H.R. REP. NO. 95-595, *supra* note 44, at 371. Though the legislative history cites no other examples, the § 9-301(2) situation could not have been envisioned as the sole instance where this subsection would apply. The language is phrased as "any generally applicable law that permits perfection." 11 U.S.C. § 546(b) (Supp. II 1978). Under many state laws other interests, such as assignment of rents clauses and mechanics' liens on real property, can convey the rights which are covered by the language of the statute. See Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 3, 26-27 (1978).

164. "If the secured party files with respect to a purchase money security interest before or within 10 days after the debtor receives possession of the collateral, he takes priority over the rights of a transferee in bulk or of a lien creditor which arise between the time the security interest attaches and the time of filing." U.C.C. § 9-301(2). See generally R. HENSON, SECURED TRANSACTIONS § 7.1 (2d ed. 1979).

interest after filing in the event that bankruptcy intervenes prior to perfection. Thus, a secured party does not lose the benefit of the ten day grace period because of a bankruptcy filing.

Section 546(b), however, has broader application. Once an assignment of rents is perfected, California law permits that assignment to be effective against an entity that acquired rights in the real property before the date of perfection but after the recording of the original deed of trust.¹⁶⁵ Hence the perfection of an assignment of rents falls within the first sentence of section 546(b).

If the secured creditor has not perfected its assignment by taking possession or having a receiver appointed at the time of the commencement of the bankruptcy case, section 546(b) would appear to allow perfection after commencement by the mere act of giving notice. The statute, however, does not specify what constitutes notice for this purpose. Nor does the definition of "notice and a hearing" in section 102¹⁶⁶ provide any help. Presumably, any act that gives actual notice to the court and to the trustee would be sufficient since approval of the court is not required by the language of the statute. Such actual notice could be given by the mere filing of a sequestration petition.

It seems likely, therefore, that under the Code a mere filing of a petition for sequestration of the rents would be sufficient to perfect an assignment of rents for security purposes at the moment it is filed. The petition need not be granted. Nevertheless, because of the uncertainty that any new law inevitably engenders, prudent lenders should continue to follow the steps that were sufficient under previous law.¹⁶⁷ The

165. See note 11 *supra*.

166. 11 U.S.C. § 102 (Supp. II 1978). This subsection provides rules of construction applicable to the phrase "after notice and a hearing" or any similar phrase. The standard for notice used in § 102 is simply that which is "appropriate in the particular circumstances." *Id.* What constitutes appropriate notice in particular circumstances is left to future judicial construction.

167. The limitation on the trustee's avoiding powers contained in § 546(b) does not encompass the power to avoid preferential transfers under § 547. Consequently, the trustee may seek to avoid as a preference the rents collected by a secured creditor or a receiver within ninety days before the filing of the bankruptcy petition. Such an attempt would present the interesting question of when a transfer of an interest in rents is deemed to occur for purposes of a preference. There is, unfortunately, no uniform answer to this problem.

Subsection 547(e)(1)(A) defines the word perfection for purposes of preference litigation and provides that "a transfer of real property other than fixtures . . . is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee" 11 U.S.C. § 547(e)(1)(A) (Supp. II 1978). Assignment of rents clauses contained in deeds of trust routinely will satisfy this definition since recording of the trust deed prevents subsequent purchasers of the property from taking free and clear of the security interest created by the deed. Thus, any properly recorded assignment of rents will be perfected for purposes of § 547 even though the security interest in rents remains unperfected under state law. Accordingly, the transfer, for purposes of § 547, is deemed to take

secured creditor not only should petition for sequestration of the rents¹⁶⁸ but should vigorously seek to have that petition granted.

An Absolute Assignment

Ventura-Louise held that a secured creditor with an absolute assignment need take no postdefault action to perfect its interest in rents.¹⁶⁹ The secured creditor was considered automatically entitled to all postpetition rents collected by the trustee. The result in bankruptcy

place at the moment it takes effect between the parties since § 547(e)(2)(A) provides that a transfer is made "at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time. *Id.* § 547(e)(2)(A) (emphasis added). An assignment of rents takes effect between the parties upon execution of the agreement; therefore, the date of transfer can be as early as the execution of the assignment.

A problem, however, is raised by the final provision of § 547(e). Section 547(e)(3), to which § 547(e)(2) is explicitly subject, provides that "[f]or purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred." *Id.* § 547(e)(3). The right transferred under an assignment of rents clause presumably is the contractual right to rents to which the trustor is or will be entitled as lessor or landlord. Such a conclusion was reached under the Act by Judge A. Hand in *Rockmore v. Lehman*, 129 F.2d 892, 893 (2d Cir. 1942). Thus, for preference purposes, the transfer of an interest in rents cannot occur until the trustor has a right to rents from the underlying property, *i.e.*, at the time it as lessor executes a lease covering that property. Until this moment the trustor has no rights in the property which the assignment clause putatively transferred. Nor can it be said that the trustor acquires rights in the rents only as the rents become due under the lease. When a lease is signed the lessor has a contractual right to rents which may be assigned.

Application of § 547(e)(3) can often lead to an anomalous result. For instance, if the property involved were a shopping center, the assignment of rents might cover dozens of leases entered into at various points in time. If the lender took possession and collected rents before filing of a petition in bankruptcy, the portion of those rents attributable to leases entered into within ninety days before filing would be voidable as a preference. Thus, part of the rents collected by the lender would amount to a preference and part would not. This result, although awkward, seems mandated by strict application of the language of the statute.

A more serious problem for lenders arises where the debtor receives rents pursuant to month to month rental agreements rather than leases. Since the right to rent arises each month as the rental payment becomes due, rather than upon execution of the rental agreement, it seems that the debtor has no transferrable right until each rent payment accrues. Thus, it is likely that a trustee will be able to avoid as a preference all rents collected by the creditor in possession, the right to which accrued within ninety days before bankruptcy.

Note that for preference purposes it is immaterial whether an assignment clause is deemed to be absolute or for security purposes as both satisfy the definition of perfection contained in § 547(e)(1)(A).

168. There is, in addition, an entirely distinct reason for having the rents sequestered. If the rents are labeled cash collateral, see note 170 *infra*, then they must be sequestered or otherwise accounted for by the trustee. 11 U.S.C. § 363(c)(1) (Supp. II 1978). By petitioning for sequestration of the rents the secured creditor not only can be assured of perfecting its lien on the rents, but also can be assured that the trustee is performing its duty to segregate cash collateral.

169. See notes 103-12 & accompanying text *supra*.

court thus should be that no further action is required to be taken. As noted earlier, however, there is uncertainty in California law regarding this question.¹⁷⁰ *Butner* requires an approximation of the result that would be reached under state law. Yet it is not known whether California courts would grant a perfected security interest in rents to the secured creditor who took no action, even if that creditor held what was labeled an absolute assignment. It is wise, therefore, for all secured creditors to take the same steps necessary to perfect an assignment for security purposes. The trustee is likely to argue that some action is necessary to perfect this interest. To forestall this contention and to be assured of a right to the rents, the secured creditor should seek to have the rents sequestered.

Conclusion

The effect of an assignment of rents clause in a bankruptcy case can vary considerably.¹⁷¹ Nonetheless a few general rules can be established. *Butner v. United States* directs that state law will determine the validity and scope of security interests in postpetition rents. California recognizes two types of security interests that may be included in a trust deed—an assignment of rents for security purposes and an absolute assignment of rents.

A secured creditor who has an assignment of rents for security purposes becomes entitled to those rents as soon as it takes possession or secures the appointment of a receiver.¹⁷² Once in possession, it can collect all accrued but uncollected rents and all rents accruing while it remains in possession. If a bankruptcy case is filed before the secured

170. See text accompanying note 72 *supra*.

171. "The one area of the use of collateral problem that has been substantially litigated is the one of rents accruing from encumbered real estate during the pendency of a bankruptcy proceeding. The case results, unfortunately, have hardly been illuminating. They go off in every direction, and while it is possible to discern a few basic rules, a case may be found in support of virtually every proposition that someone wishes to advance." P. MURPHY, CREDITORS' RIGHTS IN BANKRUPTCY § 7.13 (1980).

172. A creditor who is in possession nevertheless may be ousted by the trustee. Section 542 requires that entities in control of property that the trustee may use, sell, or lease under § 363 must deliver and account for such property to the trustee. 11 U.S.C. § 542 (Supp. II 1978). Property that the trustee may use, sell, or lease under § 363 is "property of the estate" as defined in § 541. *Id.* § 363(b). Section 541 contains a broad description of what constitutes property of the estate: "All legal or equitable interests of the debtor in property." *Id.* § 541(a)(1). The subject property likely will be considered property of the estate even if the debtor is no longer in possession. Prior to a foreclosure sale the debtor retains certain rights in the property even if it has lost the right to possession and to collect rents. As long as the debtor retains some rights it seems likely that the property will be considered to come within the expansive scope of § 541. If it does, the creditor becomes obligated to turn over the property to the trustee. If a receiver is in possession a similar result will be reached under § 543.

creditor has perfected its lien and becomes entitled to the rents, the creditor must file a complaint in the bankruptcy court to modify or terminate the automatic stay of section 362 and to have the rents sequestered or otherwise set aside for its benefit. If granted, the creditor in a straight bankruptcy will prevail over the debtor and over the trustee seeking the rents for the benefit of unsecured creditors.¹⁷³

The absolute assignment of rents presents a more difficult situation. Until *Ventura-Louise*, rights from an absolute assignment of rents were largely theoretical and were acknowledged only in dictum; their practical effect was unexplored. Although the result in *Ventura-Louise* is clear, it is based on a questionable interpretation of state law. The holding in that case should not be relied upon by secured creditors. A prudent creditor should take nothing for granted and should seek to

173. Section 363 allows the trustee to use, sell, or lease property of the estate under certain circumstances. The Code makes a distinction between property of the estate which is cash collateral and that which is not cash collateral. Cash collateral cannot be used, sold, or leased by the trustee in the ordinary course of business unless each entity with an interest in the collateral consents or the court, after notice and a hearing, authorizes the trustee's proposed action. *Id.* § 363(c)(2). If use, sale, or lease of the cash collateral is authorized, the court must provide "adequate protection" for any entity with an interest in the collateral. *Id.* § 363(e). Adequate protection is defined somewhat vaguely in § 361. If the trustee does not propose to use, sell, or lease cash collateral or the court refuses to authorize the trustee's proposed use, sale, or lease, then the trustee is under a duty to segregate and account for any cash collateral under his or her control. *Id.* § 363(c)(4). Property of the estate which is not cash collateral, in contrast, can be used, sold, or leased by the trustee in the ordinary course of business without notice and a hearing. *Id.* § 363(c)(1). Nor is the trustee under any duty to segregate and account for property which is not cash collateral. Thus, from a creditor's point of view a lien on cash collateral is preferable to a lien on property of the estate which is not cash collateral.

A creditor possessing an assignment of rents clause will want to contend that rents being collected from the subject property come within the definition of cash collateral. If the interest in rents is perfected under state law the creditor should be successful. Section 363(a) defines cash collateral as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and an entity other than the estate have an interest." *Id.* § 363(a). Rents obviously qualify as cash; the only point of issue would be whether the creditor "has an interest" in those rents. If a creditor has an absolute assignment it should have an interest in rents regardless of whether it has taken any action after default. The assignment, being absolute, transferred a present interest in rents. In theory, no further action on the creditor's part is necessary for it to be entitled to the rents. Therefore, rents received by the trustee which are subject to an absolute assignment should automatically be considered cash collateral.

Rents collected by the trustee which are subject to an assignment for security purposes are more problematic. The assignment for security purposes creates only an inchoate lien which must be perfected before it is effective. Prior to perfection it is open to question, therefore, whether a creditor has an interest in the rents. The creditor could contend that the lien, even though prospective, is sufficient to meet the broad definition of "lien" contained in § 101(28). *Id.* § 101(28). If the assignment for security purposes qualifies as a lien then the creditor would seem to "have an interest" in the rents. Nevertheless, a court may decide otherwise since the interest is not effective until it is perfected. To be careful, therefore, the creditor should perfect the assignment as soon as possible after filing.

have the rents sequestered. Petitioning for sequestration to enforce rights under an absolute assignment rather than merely to perfect a security interest is safer than arguing that a particular assignment clause is absolute or that an absolute assignment need not be perfected. If the rents are sequestered, the distinction between an assignment for security purposes and an absolute assignment becomes meaningless.

